King County

Finance and Business Operations Division
Department of Executive Services
821 Second Ave.
Seattle, WA 98104-1598

July 15, 2008

Honorable County Executive, Members of the Metropolitan King County Council, and King County Residents

We are pleased to transmit to you the Comprehensive Annual Financial Report (CAFR) of King County, Washington (the County), for the fiscal year ended December 31, 2007. The governmental financial reporting model provides a picture of the County as a single, unified entity, while continuing to provide traditional fund-based financial statements. Each perspective (government-wide and major fund) allows the reader to address relevant questions, provides a basis for comparison, and enhances the County's accountability.

The CAFR consists of management's representations concerning the finances of the County. Consequently, management assumes full responsibility for the completeness and reliability of all information presented in this report. To provide a reasonable basis for making these representations, management has established a comprehensive internal control framework designed to protect the government's assets from loss, theft, or misuse, and to compile sufficient reliable information for the preparation of the County's financial statements in conformity with Generally Accepted Accounting Principles (GAAP). Because the cost of internal controls should not outweigh their benefits, the County's comprehensive framework of internal controls has been designed to provide reasonable rather than absolute assurance that the financial statements will be free from material misstatements. As management, we assert that, to the best of our knowledge and belief, the CAFR is complete and reliable in all material respects.

The County's financial statements have been audited by the Washington State Auditor's Office. The goal of the independent audit was to provide reasonable assurance that the basic financial statements of the County for the fiscal year ended December 31, 2007, are free of material misstatements. The independent audit involved examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements; assessing the accounting principles used and significant estimates made by management; and evaluating the overall financial statement presentation. The auditor concluded, based upon the audit, that there was a reasonable basis for rendering an unqualified opinion that the County's financial statements for the fiscal year ended December 31, 2007, are fairly presented in conformity with GAAP. The auditor's report is presented as the first component of the financial section of this report.

The independent audit of the financial statements of the County was part of a broader, federally mandated "Single Audit" designed to meet the special needs of federal grantor agencies. The standards governing Single Audit engagements require the independent auditor to report not only on the fair presentation of the financial statements, but also on the audited government's internal controls and compliance with legal requirements, with special emphasis on internal controls and legal requirements involving the administration of federal awards. These reports will be available in the County's separately issued 2007 Single Audit Report, due September 30 (available online at http://www.sao.wa.gov).

Management's discussion and analysis (MD&A) immediately follows the independent auditor's report and provides a narrative introduction, overview, and analysis of the basic financial statements. The MD&A complements this letter of transmittal and should be read in conjunction with it.

Profile of the County

The County ranks number one in population in the State of Washington and is the financial, economic, and industrial center of the Pacific Northwest Region. Located between the sparkling blue waters of Puget Sound and the snowcapped Cascade Mountains, the County consists of 2,131 square miles, ranking 11th in geographical size among Washington state's 39 counties. As of December 31, 2007, the County contained 39 incorporated cities, which accounted for approximately 80 percent of its population.

King County operates under a Home Rule Charter adopted by a vote of the citizens of King County in 1968 and is organized under the Executive-Council form of county government. The Metropolitan King County Council is the policy-determining legislative body of the County. The Council's nine members are elected by district to four-year staggered terms and serve on a full-time basis. The County Council sets tax levies, makes appropriations, and adopts and approves the annual operating and capital budgets for the County. Other elected County officials include the County Executive, Prosecuting Attorney, Sheriff, Assessor, and Superior and District Court Judges. All are partisan positions, elected to four-year terms, except for the Sheriff and Judges, which are nonpartisan positions.

The County Executive serves as the chief executive officer of the County. The County Executive presents to the County Council annual statements of the County's financial and governmental affairs, the proposed budget, and capital improvement plans. The County Executive signs, or authorizes the signing of, all deeds, contracts, and other instruments on behalf of the County, and appoints the director of each executive department.

King County provides some services on a countywide basis and other services only to unincorporated areas. Within appropriate jurisdictions, the County provides public transportation, road construction and maintenance, wastewater treatment, flood control, agricultural services, parks and recreation facilities, law enforcement, criminal detention, rehabilitative services, court services, tax assessments and collections, land use planning and permitting, zoning, public healthcare, emergency medical services, election services, animal control, and the disposal of solid waste. In addition, the County has contracts with some cities to provide services to incorporated areas within the County.

In 2007 the reporting entity "King County" includes five component units: (1) the Harborview Medical Center (HMC); (2) the Washington State Major League Baseball Stadium Public Facilities District (PFD); (3) the Cultural Development Authority of King County (CDA, dba 4Culture); (4) the Flood Control Zone Districts; and (5) the Building Development and Management Corporations. The Harborview Medical Center, with a history dating back to 1877, is a comprehensive 413-bed healthcare facility operated since 1967 by the University of Washington under a management contract. The general conditions of the management contract specify that King County retains title to all real and personal property acquired with HMC capital or operating funds. The PFD is responsible for overseeing the maintenance and operation of Safeco Field, the Seattle Mariners' baseball stadium. The CDA was created in 2003 to support the arts, heritage, historic preservation, and public art throughout the county. The Flood Control Zone Districts account for the development, operation and maintenance of flood control or storm water control projects that benefit specific areas of the county. The Building Development and Management Corporations are four Washington state nonprofit corporations each of which are single-purpose entities that were created to assist the County in the development and construction of public buildings.

Most funds in this report pertain to the entity King County Government. Certain Agency Funds pertain to the County's custodianship of assets belonging to independent governments and special districts. Under state statute and the County's Home Rule Charter, the King County Executive is the *ex officio* treasurer of all special purpose districts in King County, but not of cities and towns or the Port of Seattle. As provided by County ordinance, the Director of the Finance and Business Operations Division is responsible for the duties of the comptroller and treasurer. Money received from or for the special purpose districts is deposited in a central bank account. The Director of the Finance and Business Operations Division disburses money according to state and local regulations and invests cash balances based on standard agreements with the respective special purpose district's governing body or administrative officer.

Factors Affecting Financial Condition

The information presented in the financial statements is perhaps best understood when it is considered from the broader perspective of the specific environment within which the County operates.

Local economy

Economic conditions have a direct impact on the County's revenues and the demand for County services. The County's revenue sources include taxes, charges for services, and intergovernmental revenues. The largest single source is taxes, which comprise approximately forty percent of total revenue, and consist primarily of taxes on real property and retail sales and use taxes. Property taxes tend to be quite stable since levy rates are calculated months in advance and King County establishes assessed value from four prior years of real estate sales. Other tax sources, such as the retail sales tax, are much more volatile and directly influenced by economic conditions in the region.

The 2001 recession had a significant adverse effect on regional employment and income growth. Economic conditions stabilized in 2003 and an expansion started in 2004 – the first increases in total regional employment in four years. County employment growth in 2007 averaged 1.8 percent above 2006 levels, a decrease from the 2.9 percent growth experienced, annually, between 2005 and 2006. Construction sector growth continues to lead job creation, but with significantly reduced momentum in 2007. Strong manufacturing employment growth in 2006, fueled in part by the cyclical ramp up in aircraft manufacturing, gave way to static manufacturing employment levels in 2007. Personal income in the County has also rebounded, with an average annual increase of 8.0 percent between 2005 and 2007, versus average growth of 0.4 percent from 2000 to 2002.

County taxable retail sales for 2007 increased by 10.77 percent over 2006 punctuating a series of years with strong growth; taxable sales growth was 6.36 percent in 2006, 7.45 percent in 2005, and 6.19 percent in 2004, all of which followed the 7.17 percent decrease in taxable sales experienced between 2000 and 2003.

Property assessment growth continues an upward trend, up 14.2 percent in 2007, compared with 10.5 percent, 8.5 percent, 5.6 percent, and 4.8 percent growth in 2006, 2005, 2004, and 2003, respectively. Assessed value appreciated even somewhat faster in 2007 than the meteoric growth experienced at the start of the decade – 12.1 percent in 2001 and 13.4 percent in 2000 – reflecting perhaps overheated market conditions. The ailing commercial market has seen a complete turnaround, countering a forecasted decline in the demand for residential property, which is only recently being realized.

County general fund property tax collections increased by 4.2 percent in 2007, compared with 2.5 percent growth in 2006, 0.8 percent in 2005, 3.6 percent in 2004, and 2.8 percent in 2003. All of these are still below the 4.5 percent growth in 2002, 4.6 percent in 2001, and 6.6 percent in 2000, the year before passage of Initiative 747. Current year property tax delinquencies were 2.01 percent, slightly above the record low set in 2006 of 1.89 percent. Delinquencies were 2.59 percent, 2.22 percent, and 2.25 percent in 2003, 2004, and 2005, respectively.

Economic outlook

Nationally, the U.S. economy struggles to deal with a liquidity crisis spurred by the over-extension and complexity of asset-backed financial instruments and risky underlying sub-prime mortgages. The Federal Reserve has scrambled to add liquidity to markets through a variety of mechanisms, including a reduction in the federal funds rate by 300 basis points since June 2006, and expanded short-term loan facilities. A $146 billion stimulus package will add a temporary boost to the economy in late 2008, but a dramatic decline in the housing sector has yet to rebound.

For 2008, negative national developments are expected to exert downward pressure on stronger local conditions. Total regional employment in 2008 is forecast to match population growth at 1.8 percent, a drop in this ratio as compared with 2007 – 3.2 percent vs. 2.0 percent and with 2006 – 3.2 percent vs. 1.6 percent. Personal income growth is also anticipated to decline from 2006 and 2007 levels, although only slightly, bolstered in part by trade benefits resulting from the weak dollar.

King County will continue to face numerous challenges, including volatile energy prices, rising employee and programmatic health care costs, and the need to raise sufficient revenues to support utility, transit system, and general government operations.

Long-term financial planning

Between 1999 and 2004, King County aggressively dealt with forecasted outyear deficits through strategic financial planning and management. In 2007, King County again forecast that status quo expenditure patterns would outpace revenues and began to address the coming deficits through a scaling back of programs, severely limiting new programs, and the creation of a reserve to cushion future deficits. The county continues to forecast outyear deficits, intensified by weak national conditions, and is proactively addressing predicted shortfalls.

The slow process of transitioning unincorporated areas to cities through annexation and incorporation continues with several successful large annexations occurring in 2007. In August, residents in the Lea Hill and Auburn West Hill annexation areas elected to join the City of Auburn. In November, Benson Hill area voters approved annexation to the City of Renton effective March 1, 2008. The Auburn annexations were effective January 1, 2008, marking the first successful major annexation to take effect. This breakthrough was spurred in no small measure by the state sales tax credit enacted in 2006 by the Washington State Legislature. Annexations must occur by 2010 in order to qualify for the credit, although no additional major annexations are anticipated in 2008.

The Washington State legislature also recently enacted streamlined sales tax sourcing legislation. This act, which conforms Washington's sales tax code with national standards, takes effect in mid-2008. The impact on countywide collections is slightly negative, but is offset by state mitigation payments. However, most unincorporated areas will see a boost in sales tax receipts of 10-12 percent.

King County still faces substantial difficulties in balancing limited revenues (largely stemming from tight constraints on property tax revenue from Initiative 747 and subsequent state legislation) with the ever-growing demand for services. Property tax growth remains capped at 1 percent plus the value of new construction. While costs since 2003 have been held well under historic growth rates of 5 to 6 percent, it will clearly be a challenge to continue to rein in expenditures in the face of labor cost drivers and service utilization levels.

The County reaffirms its steadfast commitment to maintain a 6 percent undesignated reserve policy and also its willingness to make often painful decisions in order to reduce expenditures to match revenue levels while retaining prudent reserves. At the state level, the County also continues to pursue statutory enhancements to local government revenues to more flexibly balance revenues with long-term cost pressures.

Major Initiatives in 2007

Parks and Open Space Levies Approved for Increased Maintenance, Open Space Acquisition and Regional Trail Development

The King County Parks Futures Task Force convened in November 2006 and did an in-depth evaluation of the needs of the King County parks system. In March 2007 the Task Force recommended two actions:

- A levy to renew the expiring parks operations levy; and
- A separate companion ballot measure to invest in new regional open space acquisitions, regional trail development, city open space and trail projects, and upgrades to the Woodland Park Zoo.

With slight modifications to the recommendations of the Task Force, two ordinances authorizing two measures were placed on the August 21, 2007 primary election ballot and approved by the voters.

Parks Operating Levy

The first ballot measure renews the parks operating levy that expired at the end of 2007. This measure renews and restores funding for King County parks, trails and open spaces. King County has made significant investments in a system that boasts one of the nation's largest inventories of county parks and trails. The renewal levy authorizes a property tax lid lift of five cents per $1,000 of assessed valuation for a period of six years. This levy is consistent with the expired (2004-2007) parks operating levy, and supports the continued operation and maintenance of regional parks, local rural parks, the community partnerships grant program, and expenditures attributable to these purposes. The five cents breaks down into the following categories:

- 4.44 cents with an inflator to renew the expiring 4.9-cent levy.
- 0.56 cents for enhanced maintenance in regional parks and facilities to match 2002 levels. The 2003 Parks levy was an emergency levy designed to be bare bones and as low cost as possible during the county budget crisis. Today, county parks maintenance levels remain well below those in place in the system prior to the budget crisis in 2002, and well below that observed in nearly all city parks systems in King County. Maintenance levels were trimmed back significantly from 2002 levels and are currently much lower than those of the surrounding cities. The 0.56 cents brings maintenance levels back up to 2002 levels. While much improved, even this would still be at a lower standard than the cities in King County.

Parks Expansion Levy

The second ballot measure authorizes King County to levy an additional property tax of five cents per $1,000 of assessed valuation for a period of six years for expansion of open space and trails by both King County and cities, and funds environmental education and conservation programming and capital improvements at the Woodland Park Zoo.

The five-cent parks and recreation opportunities expansion levy supports expanding trails, open spaces and recreation opportunities throughout King County. By supporting county and city recreation systems, this levy recognizes the reality that these systems are interdependent in many respects: residents use both systems, and the County's trail system is designed to enhance linkages between them. This levy is an important step forward in addressing an ever increasing demand for more recreational assets in the future. It is projected that at least 280,000 more people will live in King County 20 years from now than are here today. As stated in the Task Force report, if we are to have any hope of meeting the recreational and environmental needs ahead, we must act now. Opportunities to preserve open space and secure regional trail right of way are few and may escape us completely if we do not have funding capacity to seize these opportunities when they arise.

Consistent with the recommendation of the Parks Futures Task Force, levy proceeds would be directed to three distinct elements, as follows:

- 3 cents to King County for acquiring and preserving additional open space and natural lands as well as acquisition and development of key regional trails identified within the County's regional trails plan. The focus for open space and natural lands acquisition will be on protecting additional resource lands, shorelines, and streams within our watersheds. Priority will be given to those projects which utilize efficient funding tools such as transfer of development rights. Trail priorities would be based on securing and developing key urban trail corridors with an emphasis on those that link city-to-city, community-to-community, and urban King County-to-rural King County with primary consideration given to those projects that address health disparities/health inequities as recognized in the Health of King County 2006 report. This funding will allow the Parks Division to build on its success to date in developing and maintaining one of the largest urban regional trail and open space systems in the country.
- 1 cent to be distributed to cities, of which fifty percent shall be distributed based on city population and the remaining fifty percent based on the assessed value of parcels within a city, to be used for trail and open space projects. Trail projects must support connections to the regional trail system, defined to include both County and city regional trails and may specifically include local trails in underserved areas linking to city or County trails.
- 1 cent to the Woodland Park Zoo. This one-time funding recognizes the unique regional contribution of the Zoo. It will expand the Zoo's environmental education and conservation programs and fund capital improvements to Zoo facilities. The County has previously recognized the regional value of the Zoo, for example, by sponsoring issuance in the 1980s of a $31.5 million voter approved bond measure for major zoo capital improvements.

<u>Chinook Office Building Completion</u>

According to space planning policy guidelines to reduce County agency dependence on short-term leased space the Chinook Building was completed in 2007. It was constructed at the site of the former County parking garage on 5th Avenue.

This 13-story, 296,000 square foot facility was completed in late 2007. Approximately 1,200 employees from eight agencies have been moved from leased space to the Chinook Building. The largest agencies are the Public Health Department, the Department of Community and Human Services, Office of Information Resource Management and the Finance & Business Operations Division.

The facility was designed and constructed consistent with green building standards. "Leadership in Energy and Environmental Design" (LEED) certification for the building is pending. The pending certification is at the Gold category for the building shell and core and Platinum for the building interior.

King County Flood Control Zone District

The countywide King County Flood Control Zone District was established in 2007 to protect public health and safety, regional economic centers, public and private properties and transportation corridors. The newly created district will be instrumental in addressing the backlog of maintenance and repairs to levees and revetments, acquiring repetitive loss properties and other at-risk floodplain properties, and improving countywide flood warning and flood prediction capacity beginning in 2008.

The King County Flood Control Zone District (FCZD) is an independent special purpose district of the State of Washington. The District levy rate is set to complete a ten year work plan to rehabilitate most of the County's flood protection system.

All 9 members of the King County Council sit as the District's Board of Supervisors. In addition, the District's governance structure is comprised of an advisory committee of elected representatives from throughout the county who make recommendations to the FCZD Board of Supervisors.

The FCZD will replace 12 separate districts that addressed areas of localized flooding, with little or no coordination between them. The new countywide FCZD is aimed at saving lives, protecting property and ensuring that a significant portion of King County's economic infrastructure is safe from the damage that can be caused by flooding.

King County Ferry District

King County is made up of expansive bodies of water that touch a growing number of communities and employment centers. Years ago, a "mosquito fleet" of small passenger ferries was used to move people and goods throughout the region. In recent years as traffic congestion has become an increasing problem, the idea of again looking to passenger ferries as a possible transportation option has become more and more attractive.

As the population of the Puget Sound region continues to grow, so will the pressure on our transportation system. By expanding the set of transportation choices to include passenger-only ferries, the County can prepare for continued population and economic growth and address the quality of life issues related to managing traffic congestion and its impact on our environment.

In addition, King County will be faced with at least two major road construction projects in the coming years, the Alaskan Way Viaduct and the 520 bridge replacement. Adding these projects to an already struggling traffic situation will further complicate our ability to move people and goods in our county. An established passenger-only ferry system will assist in the mitigation of these projects and expose more potential customers to the benefits of this transportation option.

In 2006, the Washington State Legislature directed that state funding for the Vashon Island passenger-only ferry service, currently operated by Washington State Ferries (WSF), end on June 30, 2007. Engrossed Substitute Senate Bill (ESSB) 6787 provided that a county with a population greater than one million persons and a boundary on Puget Sound that wanted to create a ferry district, could submit a business plan to the Governor no later than November 1, 2006 for assumption of the Vashon service by the ferry district. The state was willing to extend their operation of the Vashon service beyond June 2007 provided a county proposed a business plan for eventually assuming the service. The Governor approved King County's business plan to create a ferry district on April 27, 2007.

On April 30, 2007 the King County Council unanimously adopted ordinance 15739 that established the framework for a King County Ferry District that corresponded with the boundaries of King County. Under legislative authority provided by the State in 2003, local ferry districts are eligible to receive funding for operations through a property tax levy. On November 13, 2007 Ferry District Resolution 2007-06.2 authorized a countywide property tax levy equal to 5.5 cents per $1,000 of assessed valuation for collection in 2008. This level of tax would allow the assumption of the Vashon and Elliott Bay passenger-only service along with the study and implementation of up to five future demonstration routes with the financial capacity to convert these routes to permanent service.

Cash Management Policies and Practices

King County managed a $4 billion (annual average) investment pool (the Pool) during 2007 and distributed nearly $200 million in interest to a combination of County agencies and 100 other special districts and public authorities participating in the Pool. The Pool is one of the largest in the State of Washington, with County funds comprising about 40 percent of the pool and outside districts the remaining 60 percent.

An Executive Finance Committee (EFC) establishes County investment policies and oversees the investment portfolio to ensure that specific investments comply with both those investment policies and Washington State law (RCW 36.48.070). The Pool is only allowed to invest in certain types of highly-rated securities including certificates of deposit, US treasury obligations, federal agency obligations, municipal obligations, repurchase agreements and commercial paper.

The Pool seeks to obtain a market rate of return while preserving and protecting capital. Over the past 13 years, the pool has averaged about a 5 percent rate of return. All County money is invested in the Pool. During 2007, the Pool realized an average yield of 5.08 percent, up from 4.68 percent in 2006. Interest earnings of County funds in the pool in 2007 were over $53 million, including over $16 million for the General Fund.

Because of unprecedented turmoil and uncertainty in global credit markets surfacing in late August 2007, the County halted all purchases of commercial paper. In early September 2007, the County commissioned an outside financial consultant, Public Financial Management (PFM), to review the pool's remaining investments in commercial paper and make recommendations going forward. PFM validated the County's strategy of halting the purchase of any new commercial paper and recommended holding remaining assets to maturity dates, while monitoring new developments in the commercial paper markets.

Using the PFM recommended strategy, the investment pool substantially reduced its exposure in commercial paper from 25 percent of the portfolio in August 2007 to about 5 percent as of February 2008. During this seven-month period, the pool has received full payments on 24 holdings of commercial paper totaling $831 million. The only commercial paper remaining in the pool is associated with four impaired investments totaling $190 million.

The four impaired commercial paper assets are Cheyne, Mainsail, Rhinebridge and Victoria. Each impaired asset is part of an "enforcement event" in which a trustee takes over the administration of the programs and determines the best way to liquidate assets or restructure the portfolio. Enforcement events are specifically designed to protect the interests of senior creditors, such as the County. At year-end, the County recorded an unrealized loss of $83.3 million for the pool of which $30.0 million was allocated to county funds. The financial status of the investments will become clearer as the investments' restructuring proposals are fully implemented. The county expects implementation to occur in the second half of 2008.

Standard & Poor's (S&P) first rated the Pool in 2005 and granted the pool its highest credit rating of AAAf. The pool continued to earn this highest rating in 2006 and again in 2007. In mid-January 2008, S&P took the temporary action to suspend their rating of the pool pending the outcome of enforcement events associated with each impaired investment. The County fully expects to see its AAAf rating restored as restructuring proposals are publicly announced and executed on each impaired investment.

Risk Management

As a municipal organization, the County has a wide range of loss exposures. The County uses three internal service funds to account for and finance property/casualty, workers' compensation, and employee medical and dental benefits self-insurance programs. Note 10 – Risk Management discloses the specific programs and claims liability changes during 2007 for each insurance program.

Pension Benefits

Qualifying County employees participate in the Public Employees' Retirement System (PERS), the Law Enforcement Officers' and Fire Fighters' Retirement System (LEOFF), the Public Safety Employees' Retirement System (PSERS), or the Seattle City Employees' Retirement System (SCERS). PERS, LEOFF, and PSERS are statewide local government retirement systems administered by the State of Washington's Department of Retirement Systems under cost-sharing, multiple-employer defined benefit and defined contribution public employee retirement systems. Note 8 – Pension Plans presents plan descriptions and information on funding policies.

Awards and Acknowledgements

The Government Finance Officers Association of the United States and Canada (GFOA) awarded a Certificate of Achievement for Excellence in Financial Reporting to King County for its comprehensive annual financial report for the fiscal year ended December 31, 2006. This was the 26th consecutive year that the County has achieved this prestigious award. In order to be awarded a Certificate of Achievement, a government must publish an easily readable and efficiently organized comprehensive annual financial report. This report must satisfy both generally accepted accounting principles and applicable legal requirements.

A Certificate of Achievement is valid for a period of one year only. We believe that our current comprehensive annual financial report continues to meet the Certificate of Achievement Program's requirements and we are submitting it to the GFOA to determine its eligibility for another certificate.

The preparation of this report would not have been possible without the efficient and dedicated services of the Financial Accounting staff of the Finance and Business Operations Division. We would like to express our appreciation to all members of the division who assisted and contributed to the preparation of this report. Credit must also be given to the Executive and County Council for their support for maintaining the highest standards of professionalism in the management of the County's finances.

Respectfully submitted,

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